18. Sunlink's Corporate cost allocation process provides an opportunity for the regulated telephone operations to subsidize BellSouth's nonregulated commercial ventures. If Southern Bell is unwilling to calculate the portion of Sunlink's lease price increases which flow into regulation, the total amount of the leases should be disallowed.

Summary

Sunlink, Inc. is a nonregulated affiliate which owns real estate and leases it to its customers which include regulated affiliates. Southern and South Central Bell lease, from Sunlink, warehouses located in Birmingham, AL, Jacksonville, FL and St. Augustine, FL. The warehouses are used for regulated operations. During the 1987-88 time period, the auditors noted that there were significant increases in the lease prices per square foot at the Birmingham and Jacksonville locations.

If there is no viable market for a service or product provided by a nonregulated affiliate, Part 64 rules require prices to be based on the calculated fully distributed cost ("FDC"). The lease prices for the warehouses are based on FDC. Overhead operating cost assignments and expense allocations within Sunlink, to a specific FDC lease location, are not "arms length" transactions. These allocations can be controlled by Sunlink, whose books and records are excluded from regulatory review. Therefore, even the application of FDC pricing for some buildings provides an opportunity to cross-subsidize the nonregulated commercial activities of BellSouth's leasing company.

Because of the unwillingness of the Company to provide specific details on Sunlink's cost allocation process, or

List of Acronyms

Acronym	Meaning
ADIT	Accumulated Deferred Income Taxes
AIC	Average Inward Cost
AT&T	AT&T Corporation
BAPCO	BellSouth Advertising and Publishing Corporation
Bellcore	Bell Communications Research
BRCS	Business Residential Calling Services
BSC	BellSouth Corporation
BSE	BellSouth Enterprises, Inc.
BSI	BellSouth International, Inc.
BSS	BellSouth Services, Inc.
BST	BellSouth Telecommunications, Inc.
CAM	Cost Allocation Manual
CAPRI	Computer Assisted Purchasing, Receiving, and Invoicing
CDAR	Customer Dialed Account Recording
CFITAP	Consolidated Federal Income Tax Allocation Policy
COE	Central Office Equipment
CPE	Customer Premises Equipment
CRIS	Customer Record Information System
CSS	Cost Separation System
CUCRIT	Capital Utilization Criteria
C&L	Coopers & Lybrand
DCPR	Detailed Continuing Property Record
DRMA	Detailed Regulatory Monthly Allocation
ESOP	Employee Stock Ownership Plan

sufficient data to justify the increases in warehouse lease prices, the auditors recommend that the cumulative increased lease amounts be disallowed as charges to regulated operations.

Criteria

Telephone companies in Georgia may not use current revenues earned or expenses incurred in conjunction with services subject to regulation to subsidize services which are not regulated or tariffed.[64] One of the objectives of this audit was to determine whether the regulated telephone operations are protected from any cross-subsidy to BellSouth's nonregulated affiliates through the cost allocation process.

Condition

The Coopers & Lybrand's ("C&L") 1991 Part 64 audit workpapers provided the auditors with information that within the 1987-1988 time period there was a significant increase in the lease price per sq. foot at warehouse locations leased from Sunlink. The 1991 Part 64 audit workpapers contained a simple series of numbers and totals comparing a present worth calculation of the lease price by year to an FDC amount. The notes in the workpapers indicate that the lease price present worth amount for Jacksonville was slightly higher than the FDC, while for other locations the present worth amounts were less than FDC. The C&L representative present during the initial review of the C&L workpapers indicated that the increase in

[64]O.C.G.A Section 46-2-23(g).

lease price per square foot resulted from changes in Sunlink's mechanized cost allocation system. Several months later, Southern Bell's response to the auditors's data request stated that the year over year lease price per sq. foot increase was because of additions to the warehouse buildings and parking lots. The new lease prices for the properties indicates that the change in lease prices applied not only to new additions, but to areas that had been previously leased. The auditors requested information pertaining to the allocation of FDC for the leases and data on the allocation process used to assign cost within Sunlink. Details relating to Sunlink's mechanized cost allocation system were not made available to the auditors. Neither Company nor C&L representatives provided any specific details relating to the basis for the fully distributed cost amount used in the new leases or any information relating to the allocation of cost within Sunlink.

The Company now contends that sufficient information is available in C&L's files to verify that lease prices are equal to or less than FDC cost. Without specific data on Sunlink's cost allocation process, it is impossible to independently determine whether the cost allocation to each location is appropriate. Although the data may be in C&L's files it was not included in the 1991 Part 69 audit workpapers, nor has any C&L representative referenced the existence of such records during numerous interviews on this subject.

Effect

Without access to sufficiently detailed information, relating to the cost allocation within Sunlink there is no way to determine if BellSouth is using its regulated telephone operations to provide a subsidy to its nonregulated commercial leasing operations. Virtually all of Sunlink's corporate overhead costs could be assigned to the properties that are priced at FDC. This would provide a subsidy to BellSouth's commercial leasing operations.

Cause

The Company continues to maintain that virtually all of the cost and lease data involving Sunlink properties and its internal cost allocation process is "proprietary" even though all of the property's lease costs are assigned to regulated telephone operations.

Recommendation

Because of the unwillingness of the Company to provide specific details on Sunlink's cost allocation process, or other data which would justify the increases in warehouse lease prices, the auditors recommend that the cumulative increases to the lease amounts be disallowed. The auditors also recommend that the Commission require the Company to provide specific detailed calculations as to the amount of these increases flowing to Georgia's regulated intrastate operations. If the Company is unwilling to calculate the portion chaining into Georgia's operations, the total amount of these leases should be disallowed as charges to regulated operations. Because the Company has refused to provide Sunlink's cost allocation information to the auditors, the Commission should require the Company to provide this information directly to the Commission.

19. **Commercial space which is leased from a nonregulated affiliate for regulated operations should be evaluated to determine if the lease space is actually being utilized.**

Summary

During the audit, two field trips were made to 3700 Colonnade in Birmingham, Alabama. The 3700 building is one of three buildings being leased from Sunlink (an affiliated company) at that location. During these visits, the auditors noted that a significant amount of floor space at the 3700 Colonnade location was unoccupied. The auditors recognize that there could be many reasons for this vacancy: reorganizations; reduction in work force; or simply that more space was leased than is required for the operations located in Birmingham.[65] If excessive space is being leased by a regulated company from Sunlink, then Sunlink would be receiving a subsidy from regulated operations. The auditors recommend that the Commission perform regular future audits focussed on all real estate and lease transactions which involve affiliates in any way.

Criteria

Georgia telecommunications companies may not use current revenues earned or expenses incurred in conjunction with services subject to regulation to subsidize services which are not regulated

[65]The vacancy in question was due to reorganization.

or tariffed.[66] One of the objectives of this audit was to determine if the Company's regulated customers are protected for cross-subsidy relating to the Company's nonregulated affiliates. The Commission has defined cross-subsidy as any action undertaken by SBT which results in an understatement of intrastate regulated revenues or an overstatement of intrastate regulated expenses or investment for SBT.[67]

Condition

The lease price for these three buildings at the Colonnade location is based on a fully distributed cost ("FDC") methodology. The costs of these leases flow directly into the regulated operations. It was noted that significant amounts of floor space at the 3700 Colonnade location was unoccupied, but this observation spanned a limited time when BellSouth was involved in massive reorganization.

Effect

Regulated operations may be paying BellSouth's nonregulated operations for floor space which is not required. Most companies with unused lease space attempt to sub-lease the space in an effort to reduce their cost of operations. In this case, there is a reduced incentive to take such action since the expense incurred by the regulated operations is passed on through to ratepayers. If

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[66]O.C.G.A Section 46-2-23(g).

[67]Docket No. 3987-U.

the regulated operations attempted to sub-lease or renegotiate the leases, then Sunlink's business would be impacted. The leasing of excessive space by the regulated operations could be significantly underwriting Sunlink's operating cost.

Cause

There could be many reasons for this condition: reorganizations; reduction in work force; or simply more space was leased than is required for the operations located in Birmingham. The auditors understand that the vacant space at Colonnade resulted from a reorganization.

Recommendation

The auditors recommend that the Commission perform regular future audits focused on all real estate and lease transactions which involve affiliates in any way.

20. **Commission should perform regular future audits focussed on real estate and lease transactions which involve affiliates in any way. An intrastate adjustment of $321,609 should be made to the Surveillance Report to compensate regulated customers for excessive Chastain Center lease expenses.**

Summary

In March 1989 Southern Bell ("SB") moved its Engineering, Business and Forecast operations from Whitlock to the Chastain Center, which was owned by Sunlink (a nonregulated affiliate). In March 1990, SB also moved its Outside Plant Control Center ("OPCC") operations from Whitlock to the Chastain Center. These moves and the resulting affiliate leases were negotiated by BellSouth Services, a subsidiary of Southern Bell. The lease at Whitlock did not expire until October 1991 and was renewable at a lower price than the Chastain Center lease price. The Whitlock lease price was $5.11 per sq. ft., while the Chastain Center lease price was $7.00 for the first two years, with an escalator provision which would increase the square foot lease price to $16.50 over a 15 year period. In addition to the higher lease price at Chastain Center, Southern Bell also incurred a $400,000 penalty because it relocated from Whitlock before the end of its existing lease.

BellSouth's corporate structure tends to create a predisposition by telephone company managers in favor of nonregulated affiliates' profits and against general trade competition. In this case, leasing from Sunlink rather than the existing nonaffiliated landlord produced additional profits to the vertically integrated entity.

The combination of vertical integration and rate of return regulation also tends to generate decisions by operating companies to enter into transactions with nonregulated affiliates that may not be economically justified. The decision in question resulted in a higher cost than would have resulted had the Company maintained its operations at Whitlock and used excess Southern Bell owned space wherever possible. BellSouth's profits were maximized since, even under modified rate of return regulation, Southern Bell's operations tend to remove the negative impact of uneconomical additional expense. The extra cost is simply absorbed as a regulated expense, allowing extra profits to flow up to the corporate parent rather than to non-BellSouth companies or regulated telephone customers.

The auditors recommend that the Commission strongly discourage leases by regulated operations from a nonregulated affiliate company, unless it can be clearly demonstrated that such leases result in reduced cost to the regulated utility and are not anticompetitive in nature. The Commission should perform regular future audits focussed on real estate and lease transactions which involve affiliates in any way. The auditors also recommend that there be a positive adjustment of $428,812 ($321,609 intrastate) to the Company's net income as reported on Southern Bell's Surveillance Report. This adjustment would compensate regulated customers for the excessive expense being assigned to regulation.

Criteria

The auditors analyzed the economic evaluation used by the Company to support the initial decision to relocate operations from Whitlock to the Chastain Center. The Chastain Center leases and current intercompany billing were also analyzed. This analysis focused on whether BellSouth used its corporate structure to benefit its nonregulated companies at the expense of its regulated customers. The auditors' analysis also focused on whether BellSouth used its corporate structure, relating to this lease, in an anticompetitive manner.

Condition

In March 1989 Southern Bell moved its Engineering, Business and Forecast operations from Whitlock to the Chastain Center, which was owned by Sunlink (a nonregulated affiliate). In March 1990, SB also moved its Outside Plant Control Center ("OPCC") operations from Whitlock to the Chastain Center. The lease at Whitlock did not expire until October 1991 and was renewable at a lower price than the Chastain Center lease price. The Whitlock lease price was $5.11 per sq. ft., while the Chastain Center lease price was $7.00 for the first two years, with an escalator provision which would increase the square foot lease price to $16.50 over a 15 year period. In addition to the increased lease price at Chastain Center, Southern Bell also incurred a $400,000 penalty for relocating from Whitlock before the end of its existing lease.

The "initial economic analysis" used to support the Whitlock relocation was a present worth study that contained numerous discrepancies and omissions. Some of these are as follows:

(1) The common area cost estimate for the Chastain Center was estimated to be $.65 per sq. ft. per year over the lease life. This estimate was significantly understated. For example, in 1991 the common area maintenance cost at the Chastain Center was actually $1.05 per sq. ft. This equates to $18,340 per year more than the cost used in the initial analysis. Assuming no increase from the 1991 level difference, this correction would add $107,849 to the present value assumption for the Chastain Center.

(2) The Company's initial economic analysis assumed that the OPCC, which was located at Whitlock, would relocate to another Southern Bell owned location and, therefore, it was not included in its Chastain present value comparisons. In fact, in 1990 an additional 10,779 sq. ft. of space was leased for OPCC at Chastain Center for a 7 1/2 year $380,283 present value.

(3) Part of the justification for the move from Whitlock was a forecast of additional space needs. The Executive Summary relating to the relocation indicates that there was at least 8,518 sq. ft. of Southern Bell owned space available in addition to the 46,716 sq. ft. at Whitlock.

(4) The analysis also did not include an additional 2,617 sq. ft. for a heating, ventilation and air conditioning ("HVAC") system with a 7 1/2 year $39,701 present value lease cost and a one time $195,000[68] charge to Southern Bell.

(5) In addition to the omissions from the Chastain Center analysis, there was an inclusion of $700,000 in the economic analysis for renovation of Whitlock at Southern Bell's expense, rather than the landlord's. The auditors continued to include this $700,000 in Whitlock's cost comparison, even though this item appears somewhat questionable.

Below is a comparison of the two lease alternatives, including the items which were omitted from the original Company analysis, assuming a 7 1/2 year lease period:

[68]The auditors reduced this amount to $140,000 to reflect future energy savings.

	Whitlock	Chastain Center
Company's PV Cost Analysis	$2,633,199	$2,806,461
Items Not Included:		
(1) Additional Common Area		107,849
(2) OPCC Space[69]		0
(3) HVAC Space		39,701
(4) Early Termination of Lease		(32,000)
(5) One Time Charge		140,000
Revised PV Cost Analysis	$2,633,199	$3,062,011
Increased Present Value Cost		$ 428,812
Intrastate Present Value Cost		$ 321,609

The Company cites several intangibles as justification for incurring the increased cost associated with its decision to lease facilities from a nonregulated affiliate. One intangible, which is not cited, is the disruption and expense that occurred with the relocation of the workforce from Whitlock.

Effect

The leasing of Chastain Center effectively shifted the cost of nonrevenue producing building space from a nonregulated affiliate to regulated telephone operations. The owners of Whitlock and the other potential lease locations were competitors of BellSouth's real estate leasing company during a period of a depressed real estate market. This transfer decision is an example of how regulated operations can be used by BellSouth to assure the success

[69] The Company leased OPCC space at Chastain Center at a present value cost of $380,283 rather than occupying Company owned space at zero incremental cost as proposed in the initial Whitlock relocation evaluation.

of its nonregulated companies at a significant cost to the regulated operations. It should again be noted that BellSouth had almost two years remaining on the Whitlock lease for which it paid despite its relocation of telephone operations to an nonregulated affiliate's building.

Cause

BellSouth's corporate structure tends to create a predisposition by telephone company managers in favor of nonregulated affiliates' profits and against general trade competition. In this case, leasing from Sunlink rather than the existing nonaffiliated landlord produced additional profits to the vertically integrated entity.

The combination of vertical integration and rate of return regulation also tends to generate decisions by operating companies to enter into transactions with nonregulated affiliates that may not be economically justified. The decision in question resulted in a higher cost than would have resulted had the Company maintained its operations at Whitlock and used excess Southern Bell owned space wherever possible. BellSouth's profits were maximized since, even under modified rate of return regulation, Southern Bell's operations tend to remove the negative impact of uneconomical additional expense. The extra cost is simply absorbed as a regulated expense, allowing extra profits to flow up to the corporate parent rather than to non-BellSouth companies or regulated telephone customers.

Recommendation

The auditors recommend that the Commission take action which would strongly discourage leases by regulated operations from BellSouth's nonregulated affiliate companies unless the Company can clearly demonstrate that such leases result in reduced cost to the regulated utility and are not anticompetitive in nature. On a going-forward basis, the Commission should require:

(1) Regular future audits focussed on real estate and lease transactions which involve affiliates in any way.

(2) A positive adjustment of $428,812 ($321,609 intrastate) to the Company's net income as reported on Southern Bell's Surveillance Report. This adjustment would compensate regulated customers for the excessive expense assigned to regulation.

21. **The interest received by Southern Bell from advances to affiliates should be offset against book interest in the interest synchronization adjustment.**

Summary

Southern Bell's accounting for advances to affiliates had a negative impact on the Georgia Surveillance Report's interest synchronization adjustment. During the audit period, Southern Bell loaned substantial amounts of capital in the form of advances to BellSouth Services and received interest on those loans. BellSouth Services' interest payment reduced its net income and consequently reduced the BSS add-back adjustment on Georgia's Surveillance Report. Southern Bell treated its interest expense and interest income (i.e. the interest received from BSS) below-the-line as non-operating revenue. If the advances had not been made to the nonregulated affiliates, Southern Bell debt could have been substantially lower. A lower debt would have impacted the interest synchronization adjustment. The interest paid on those advances (1988 - 1991) totaled $8,523,109, of which Georgia's portion was $2,510,551. The auditors recommend that an adjustment be included in the Surveillance Report's NOI of $947,382 to reflect the four year audit period impact of these advances as well as a change in the Interest Synchronization calculation to reflect the interest on future advances to affiliates.

Criteria

The audit evaluated the components of the Surveillance Report which impact the Interest Synchronization Adjustment and investigated Southern Bell Advances to Bell South Services and Bell South Products, Inc. The accounting treatment for the interest payments was verified to determine the impact on the regulatory monitoring process.

Condition

During the audit period (1988 - 1991), Southern Bell made numerous "Advances" to BellSouth Services. The interest paid on those Advances totaled $8,523,109 with Georgia's portion being $2,510,551. The interest paid by BellSouth Services reduced its Net Income included in Georgia's Surveillance Report as an NOI BSS Adjustment. The interest received by Georgia from BSS was accounted for as a non-operating revenue and not included in its Net Operating Income, which is used for evaluating Southern Bell of Georgia's Rate of Return.

Southern Bell of Georgia's 1991 book interest expense was $82,161,201. If Southern Bell had not made any advances to BSS then its short-term debt could have been lower, along with its interest expense. Effectively, Southern Bell and South Central Bell were "middle-men" for BSS financing.

Southern Bell of Georgia includes a Pro Forma NOI Interest Synchronization Adjustment as part of its Surveillance Report. In establishing the Rules for Surveillance Reporting, the Commission mandated an allowable "Capital Structure". The established procedures include a provision which allows an NOI interest adjustment which is the Federal and State tax impact on the difference between the allowed Capital Structure and the actual interest paid on debt by the Company. In 1991 the allowed capital structure interest was $78.1 M while the actual Company interest recorded was $82.2 M. This difference resulted in a Pro Forma adjustment which reduced the Net Operating Income that was used in the Rate of Return evaluation by $1,542,346.

Effect

Southern Bell - Georgia received a cross-subsidy. The interest synchronization adjustment resulted in an increase to Georgia's 1991 revenue requirement as a result of the very high level of book interest expense. Obviously a portion of Southern Bell - Georgia's book interest expense is attributable to funds it borrowed and in turn advanced to BSS. Consequently, the Company was able to achieve a cross-subsidy through the interest synchronization adjustment.

Cause

Southern Bell's accounting for the interest on advances was correct, but without an adjustment in the Interest Synchronization Adjustment calculation, similar to the one for customer's deposits, the resulting negative NOI adjustment is overstated.

Recommendation

The auditors recommend that the Interest Synchronization calculation process included in the Surveillance Report be modified so that any future interest received from an affiliate will be reflected as if it is a reduction to Southern Bell's debt interest. Also, the auditors recommend a one time NOI adjustment of $947,382 to reflect the four year impact of the Affiliate advances.

22. **<u>The Company achieved a cross-subsidy relating to the Rose CXC PBX. The Commission should increase its audit scrutiny of the Company's CPE-related transactions.</u>**

<u>Summary</u>

A Private Branch Exchange ("PBX") was transferred from BellSouth Services ("BSS") to Southern Bell - Georgia's regulated books. Although the PBX was dedicated to the use of the BSS Corporate Communications Group, BSS did not pay Southern Bell for its use. Nor could the Company document the initial transfer from BSS to Southern Bell. This transaction resulted in a cross-subsidy from regulated operations to nonregulated operations. The auditors recommend increased audit scrutiny of all of the Company's CPE-related transactions.

<u>Criteria</u>

Telephone companies in Georgia may not use current revenues earned or expenses incurred in conjunction with services subject to regulation to subsidize services which are not regulated or tariffed.[70] One of the objectives of this audit was to learn whether, as a result of the relationship between the Company's regulated telephone operations and the nonregulated operations of its affiliates, Southern Bell's regulated customers are protected from cross-subsidy.

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[70] O.C.G.A. Section 46-2-23(g).

Condition

The auditors selected a judgmental sample of forty-four construction estimates closed in 1991. Of these forty-four estimates, only two related to customer premises equipment on Southern Bell - Georgia's books. Estimate No. T9546 was for the retirement of the Rose CXC PBX. Although this PBX was originally purchased by Bellsouth Services ("BSS"), it was recorded on Southern Bell - Georgia's books. The Company could not explain or document the transaction in which the PBX was transferred to Southern Bell from BSS. The audit sample was too small to determine whether this was an isolated incident.

The equipment cost ($88,755) was included as Southern Bell - Georgia Office Equipment (Account 2123), which is a directly assigned regulated investment account. Although the PBX exclusively served BSS' Corporate Communications Group, there was no lease agreement or other arrangement compensating Southern Bell for the use of the PBX. In 1991, the PBX was retired because BSS desired ESSX service, for which it paid the tariffed rates.

Effect

The Company's inability to explain or provide documentation relating to the transfer of this asset from BSS to Southern Bell indicates a lack of internal control. Furthermore, at the time this took place, BSS was an nonregulated affiliate receiving service from Southern Bell at no charge. The asset was in Southern Bell's rate base, depreciation was being charged to regulated operations, and any early retirement losses were absorbed into regulated operations.

Cause

Unknown.

Recommendation

This finding may or may not represent an isolated incident. However, it is in the CPE area in which the auditors have identified other cross-subsidies.[71] As a result of these findings, the auditors recommend increased audit scrutiny of all Company CPE-related transactions.

[71] See Finding Nos. 3 and 12.